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Canadian Income Tax Law: Cases, Text, and Materials

Volume II

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University of Toronto
2000

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Table of Contents

Part II - Sources of Income or Loss (cont)

Chapter 5
Business or Property 417
A. Introduction 417
B. Characterization 418
1. Business 420
(1) Ordinary Meaning 420
(2) Extended Meaning 426
(a) Undertaking of Any Kind Whatever 427
(b) Adventure or Concern in the Nature of Trade 432
2. Reasonable Expectation of Profit 449
C. Scope 471
1. Gains from Illegal Activities 472
2. Insurance Proceeds 477
3. Damage Payments 480
4. Interest 486
(1) Characterization 487
(2) Payments of Interest and Capital Combined 496
(3) Discounts and Premiums 510
5. Royalties 520
(1) Dependence Upon Use of or Production from Property 522
(2) Amounts Received in the Year that Depend on Use or Production 526
6. Rent 532
7. Inducements, Reimbursements, and Refunds 538
8. Prizes and Awards 551
9. Gifts 555
10. Windfalls 564

Chapter 6
Capital 571
A. Introduction 571
B. Characterization 572
C. Scope 573
1. Sale of Property 574
(1) Real Property 575
(2) Corporeal Personal Property 590
(3) Intellectual Property 598
(4) Corporate Shares 610
(5) Debt Obligations 623
(6) Canadian Securities 631
(7) Foreign Exchange 640
2. Compensation 653
(1) Loss of or Damage to Corporeal Property 654
(2) Loss or Impairment of Incorporeal Property 658
(3) Expropriation of Real Property 672

Chapter 7
Other Sources 686
A. Introduction 686
B. Characterization 686
C. Scope 687
1. Educational Assistance 687
(1) Registered Education Savings Plan Payments 688
(2) Scholarships, Fellowships, Bursaries, and Research Grants 688
(3) Student and Research Assistantships 696
(4) Student Loans, Forgivable Loans, and Repayable Awards 697
2. Art Production Grants 699
3. Prizes 699
(1) Prize for Achievement in a Field of Endeavour Ordinarily Carried on by the Taxpayer 700
(2) Prescribed Prize 705
4. Annuity Payments 707
5. Superannuation or Pension Benefits 712
6. Death Benefits 718
7. Social Assistance 721

8. Compensation for Disability or Death 723
(1) Tort Compensation for Personal Injury or Death 723
(2) Social Insurance 728
(a) Workers' Compensation 729
(b) Canada and Quebec Pension Plan Payment 731
(c) Criminal Injury Compensation 731
(3) Private Insurance 731
9. Employment Insurance and Other Assistance 732
10. Retiring Allowances 734
(1) Payments On or After Retirement in Recognition of Long Service 736
(2) Payments in Respect of Loss of an Office or Employment 741
(a) Relationship to Office or Employment 741
(b) Loss of Office or Employment 748

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Chapter 5
Business or Property

A. Introduction

In addition to each office and employment, paragraph 3(a) of the Act identifies each "business" and each "property" as additional sources of income from which taxpayers must include any income in computing their net income under section 3. Correspondingly, paragraph 3(d) permits taxpayers to deduct their losses from each business or property in computing their net income for the year.

The computation of a taxpayer's income or loss from a business or property is governed by subdivision b of Division B of Part I of the Act (sections 9 to 37.3). Subsection 9(1) defines the income of a taxpayer from a business or property as the "profit" from that business, a concept which implies the prior deduction of reasonable expenses incurred in order to obtain the income.[1] Subsection 9(2) defines a taxpayer's loss from a business or property as "the taxpayer's loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require." Subsection 9(3) stipulates that the expressions "income from a property" and "loss from a property" do not include capital gains or losses from the disposition of that property. Sections 12 to 17 specify various amounts that must be included in computing a taxpayer's income from a business or property. Sections 18 to 21 contain numerous rules both limiting and permitting the deduction of specific amounts in computing a taxpayer's income from a business of property. Sections 22 to 25 apply where a taxpayer ceases to carry on a business, while sections 26 to 37.3 apply to special cases as indicated.

Where the source of a profit or loss is characterized as a "business" or "property", income is fully taxable under subsection 9(1) and paragraph 3(a) of the Act and losses are fully deductible in computing income from all sources under paragraph 3(d). In contrast, where the source of a gain or loss is "capital", the gain is only three-quarters taxable (section 38), whereas the loss is only three-quarters deductible (section 38) and deductible only against taxable capital gains for the year (paragraph 3(b)).[2] Alternatively, where an economic gain or loss has no "source" within the meaning of the Act, neither the gain nor the loss is recognized for tax purposes.

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[1]See, e.g., *Symes* v. *M.N.R.*, [1994] 1 C.T.C. 40, 94 D.T.C. 6001 (S.C.C.) *per* Iacobucci, J., citing *Daley* v. *M.N.R.*, [1950] C.T.C. 254, 4. D.T.C. 877 (Ex. Ct.). The concepts of "profit" and "profit for a taxation year" are considered in chapter 9, *infra*.

[2]The three-quarters inclusion rate dates from 1990. For 1988 and 1989, the applicable rate was two-thirds. From 1972 to 1987, it was one-half. Prior to 1972, capital gains and losses were not recognized for tax purposes.

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Where taxpayers realize a gain, therefore, it is generally to their advantage to argue either that the gain had no source within the meaning of the Act or (less advantageously) that the source of the gain was capital rather than a business or property. Where taxpayers suffer an economic loss, on the other hand, it is generally more advantageous to characterize the source of the loss as a business or property. For the revenue authorities, it follows, the incentives are typically reversed.

This chapter considers the characterization and scope of a business and property as sources of income. Section B examines statutory and dictionary definitions of the words "business" and "property" and judicial decisions governing the characterization of an activity as a business or property for the purposes of the Act. Section C reviews various kinds of receipts that are included in computing a taxpayer's income from these sources.

B. Characterization

According to *The Concise Oxford Dictionary*, 7th edn. (Oxford: Clarendon Press, 1982) at 123, a "business" is defined as a "habitual occupation, profession, trade". Similarly, *Black's Law Dictionary*, 6th edn. (St. Paul: West Publishing Co., 1990) at 198, defines a "business" as an:

> Employment, occupation, profession, or commercial activity engaged in for gain or livelihood. Activity or enterprise for gain, benefit, advantage or livelihood. . . . Enterprise in which person engaged shows willingness to invest time and capital on future outcome. . . . That which habitually busies or occupies or engages the time, attention, labor, and effort of persons as a principal serious concern or interest or for livelihood or profit.

Thus, as one Canadian commentator has written:

> "Business" is a term of broad meaning, embracing as it does a wide range of activities which have as their object the acquisition of gain through the utilization of labour and capital in varying combinations. Sometimes the labour factor is dominant -- as in the professions -- and in others, the capital factor is dominant -- as in the business of renting land, buildings or chattels.[3]

The meaning of the word "property" is similarly broad in scope, defined in *The Shorter Oxford English Dictionary*, 3rd edn., (Oxford: Clarendon Press, 1970) at 1600 as "the right (*esp.* the exclusive right) to the possession, use, or disposal of anything" and in *Black's Law Dictionary*, *supra* at 1216, as "everything which is the subject of ownership, corporeal or incorporeal, tangible or intangible, visible or invisible, real or personal".

For the purposes of the *Income Tax Act*, the words "business" and "property" are given specific meanings in subsection 248(1). According to the definition of "business" in subsection 248(1):

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[3]Douglas J. Sherbaniuk, "The Concept of Income - The Receipts Side" *Studies of the Royal Commission on Taxation*, Number 20 (February 1967) at 29-30.

Chapter 6
Capital

A. Introduction

In computing a taxpayer's net income for a taxation year, paragraph 3(b) includes what was described in chapter 1 as the taxpayer's "net taxable capital gain", which is determined by deducting the taxpayer's "allowable capital losses" for the taxation year (other than losses from the disposition of "listed personal property" and "allowable business investment losses") from the sum of the taxpayer's "taxable capital gains" from the year (other than gains from dispositions of "listed personal property") and the taxpayer's "taxable net gain for the year from dispositions of listed personal property".

The rules governing the computation of these amounts are contained in subdivision c of Division B of Part I of the Act, comprising sections 38 to 55. As a general rule, the gains that are subject to tax under these provisions are determined by subtracting the cost of the property from the proceeds received on its disposition, while losses occur where the cost exceeds the proceeds.[1] Section 38 defines the "taxable" portion of a capital gain and the "allowable" portion of a capital or business investment loss as three-quarters of the amount of the gain or loss otherwise determined under subdivision c.[2] Likewise, subsection 41(1) defines a taxpayer's "taxable" net gain from dispositions of listed personal property as three-quarters of the taxpayer's net gain from dispositions of this kind of property.[3]

As a result, while a taxpayer's income from each office, employment, business and property is fully taxable under paragraph 3(a), only three-quarters of each capital gain is included in computing the taxpayer's net income under paragraph 3(b). On the other hand, while a taxpayer's loss from each office, employment, business or property is fully deductible from all other sources of income under paragraph 3(d), capital losses are only three-quarters deductible and are generally deductible only against taxable capital gains

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[1]See subparagraph 40(1)(a)(i) (defining a taxpayer's gain for a taxation year from the disposition of property) and paragraph 40(1)(b) (defining a taxpayer's loss for a taxation year from the disposition of property). These and other provisions regarding the computation of taxable capital gains, allowable capital losses, and taxable net gains from dispositions of listed personal property are examined in chapter 10, *infra*.

[2]The three-quarters inclusion rate dates from 1990. For 1988 and 1989 the fraction was two-thirds. From 1972 to 1987, it was one-half. Prior to 1972, capital gains and losses were not recognized for tax purposes.

[3]A taxpayer's "net gain" from dispositions of listed personal property is defined in subsection 41(2) as the the taxpayer's gains from dispositions of listed personal property in the year less the taxpayer's losses from dispositions of listed personal property in the year, less listed personal property loss carryovers which may be deducted under paragraph 41(2)(b). The term "listed personal property" is defined in section 54. The computation of a taxpayer's taxable net gain from dispositions of listed personal property is considered in chapter 10, *infra*.

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for the year under subparagraph 3(b)(ii) or in computing net gains from dispositions of listed personal property under subsection 41(2).[4]

Where taxpayers dispose of property at a gain, therefore, it is generally to their advantage to characterize the source of the gain as capital. Alternatively, where property is disposed of at a loss, it is generally advantageous for taxpayers to characterize the source of the loss as a business or property. For the revenue authorities, on the other hand, the incentives are typically reversed. This is the practical context for most of the legal disputes involving the characterization of a gain or loss.

For the purposes of this chapter, there is no need to consider the various rules by which a taxpayer's "net taxable capital gain" for a taxation year is determined, nor to examine the meaning of the terms "listed personal property" or "business investment loss".[5] Instead, building on the cases and statutory provisions considered in the previous two chapters, this chapter examines the characterization and scope of capital as a source of a taxpayer's gain or loss. Section B examines the statutory provisions by which the Act defines a capital gain or loss. Section C considers the scope of capital as a source of a taxpayer's gain or loss, examining cases and statutory provisions governing the characterization of amounts received as proceeds from the sale of various kinds of property or as compensation for the loss or destruction of property.

B. Characterization

The Act does not define the word "capital" for the purpose of determining the source of a taxpayer's gain or loss. According to paragraph 39(1)(a), however, "a taxpayer's capital gain for a taxation year from the disposition of any property" is defined as:

> the taxpayer's gain for the year determined under this subdivision (to the extent of the amount thereof that would not, if section 3 were read without reference to the expression "other than a taxable capital gain from the disposition of a property" in paragraph 3(a) and without reference to paragraph 3(b), be included in computing the taxpayer's income for the year or any other taxation year) from the disposition of any property of the taxpayer . . .

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[4]There are two exceptions to the general rule that capital losses may only be deducted against capital gains for the year. First, "allowable business investment losses", as defined in paragraphs 38(c) and 39(1)(c), may be deducted against income from all sources under paragraph 3(d). Second, where a taxpayer's capital losses for the year exceed the taxpayer's capital gains for the year, these "net capital losses" may be carried over to other taxation years under paragraph 111(1)(b). In the case of listed personal property losses, a more limited carryover is incorporated into the computation of the taxpayer's net gain from dispositions of listed personal property under paragraph 41(2)(b). Allowable business investment losses and listed personal property losses are considered in chapter 10, *infra*. Net capital losses are examined in chapter 13, *infra*.

[5]See chapter 10, *infra:*

Chapter 7
Other Sources

A. Introduction

In addition to the five sources of income identified in paragraphs 3(a) and (b) (office, employment, business, property and capital), subdivision d (comprising sections 56 to 59.1) requires taxpayers to include a variety of other amounts in computing their net income under section 3. More generally, while paragraph 3(a) refers to "the taxpayer's income for the year from each office, employment, business and property", these specific references do not "restrict the generality" of the initial requirement to include "all amounts each of which is the taxpayer's income ... from a source". As a result, as the Federal Court of Appeal affirmed in *Bellingham* v. *The Queen*, [1996] 1 C.T.C. 187, 96 D.T.C. 6075 (F.C.A.): "Paragraph 3(a) makes it clear that the named sources are not exhaustive and, thus, income can arise from other unidentified sources."

Building on the analysis of chapter 1 and the previous three chapters, this chapter reviews the main inclusions in subdivision d, as well as the more general concept of a taxpayer's income "from a source". Following the structure of the previous three chapters, section B considers the characterization of these other sources while section C examines their scope.

B. Characterization

Although the Canadian income tax is based on the concept that "income" is derived from a source, the Act does not define the concept of a "source" for the purposes of paragraph 3(a). As explained in chapter 1, however, this source concept originates in the economic theories of classical political economists who defined income according to its productive sources: wages of labour, profits or interest of capital, and rent of land. In *Bellingham*, *supra*, the Federal Court of Appeal employed a similar concept of productive sources both to explain previous cases in which gambling gains, gifts and inheritances and windfalls have been excluded from tax, and to conclude that a punitive damage award payable as "additional interest" under the Alberta *Expropriation Act* was not income from a source within the meaning of paragraph 3(a). In this respect, as Robertson, J.A. explained: "The critical factor is that the punitive damage award does not flow form either the performance or breach of a market transaction."

As also explained in chapter 1, the traditional source concept is in marked contrast to the practice of U.S. courts, which held that the words "income derived from any source